No. 15386

In the United States Court of Appeals for the Ninth Circuit

F. NORMAN PHELPS AND ALICE PHELPS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court is reported at 26 T.C. 846.

JURISDICTION

This petition for review (R. 45-50) involves federal income taxes for the taxable year 1948. On August 19, 1953, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency in the total amount of $107,926.06. (R. 11.) Within ninety days thereafter and on November 17, 1953, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939, as amended. (R. 3.) The decision of the

Tax Court was entered on July 31, 1956. (R. 44.) This case is brought to this Court by a petition for review filed October 25, 1956. (R. 45-50.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Did the Tax Court err in finding as a fact that the corporate distributions out of earnings and profits, in redemption of portions of taxpayers' stock in three corporations, were essentially equivalent to distributions of taxable dividends under Section 115 (g) of the Internal Revenue Code of 1939?

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*.

STATEMENT

The facts as stipulated to by the parties (R. 16-25) and as found by the Tax Court (R. 27-41) may be summarized as follows:

On April 10, 1946, the taxpayer,[1] Jackson Howell and James A. Kenyon, who had been operating three Chevrolet dealerships as limited partnerships, incorporated the concerns as the Capitol Chevrolet Company, the Mid-Valley Chevrolet Company and the Howell Chevrolet Company. (R. 28-29.) One-half of the stock in Capitol and Mid-Valley was issued to taxpayer and his wife Alice Phelps, and one-half was

[1] F. Norman Phelps is hereinafter referred to as the taxpayer, his wife being included as a party merely because joint returns were filed.

issued to Kenyon, represented by the Patricia May Kenyon Trust and the J. A. K. Company, a holding company, all stock of which was owned by Mr. Kenyon.[2] Taxpayer and his wife were issued 33 1/3 percent of the Howell Company stock as were Jackson Howell and the Kenyon interest. (R. 29.) Stock in the new corporations[3] from the date of incorporation until December 21, 1948, was outstanding as follows (R. 29):

Capitol Chevrolet Company

	No. of Shares
F. Norman Phelps	212
Alice Phelps	213
James A. Kenyon, Trustee of Patricia May Kenyon Trust	170
J. A. K. Company	255

Mid-Valley Chevrolet Company

F. Norman Phelps	213
Alice Phelps	212
James A. Kenyon, Trustee of Patricia May Kenyon Trust	170
J. A. K. Company	255

[2] The Patricia May Kenyon Trust was created on August 8, 1941, by James A. Kenyon for the benefit of his adopted daughter. Kenyon was not only settlor, but was trustee with power to deal with the trust property as absolute owner thereof including the power of sale. He had no beneficial interest in the income or corpus of the trust other than a remote reversionary interest. (R. 28.) The stockholdings of the trust and the J. A. K. Company will be referred to as the Kenyon interest.

[3] The dealerships were corporations prior to 1944 and operated as partnerships for only about 2 years prior to incorporation in 1946. The financial interest of the various individuals remained in substantially the same ratio throughout these transitions. (R. 24-25.)

Howell Chevrolet Company

F. Norman Phelps	150
Alice Phelps	150
James A. Kenyon, Trustee of Patricia May Kenyon Trust	120
J. A. K. Company	180
Jackson Howell	300

The taxpayer, Kenyon and Howell had similar backgrounds in the automobile business through connections over many years with the Chevrolet Division of General Motors Corporation or General Motors Acceptance Corporation. They served in various capacities such as, salesmen, used car managers, city, district, zone and regional managers, etc. (R. 30.)

The three corporations engaged in the business of operating Chevrolet dealerships under a selling agreement with General Motors which was in force for a period of one year, renewable on November 1st of each year. This agreement, which constituted the only understanding between the parties, provided for its termination by either party upon written notice, in the event either party violated or failed to comply with any of its provisions. It also provided that persons actually participating in the ownership and responsibility of a dealership must be named in the agreement. Implementing this latter provision was a policy of Chevrolet that those so named must own at least 25 percent of the stock. (R. 30-32.)

In September of 1948, J. L. Connell, the regional manager for Chevrolet, called the taxpayer to his office and advised him of a new policy adopted by General Motors under which no trust or holding company could hold stock in a Chevrolet dealership, and

that the stock ownership of the Kenyon Trust and the J. A. K. Company must be eliminated. The taxpayer, because of his long association with Chevrolet, knew that such advice concerning a change in policy must be followed and he assured Connell that the three dealerships would comply. Connell also suggested to the taxpayer that, because of the satisfactory operation of the dealerships under Howell, Kenyon and the taxpayer, it would be more than fair, after meeting the new policy, for the three of them to maintain the same percentage of ownership in the companies. Connell was not stating Chevrolet policy in making this latter suggestion and did not intend an implied threat that no new selling agreement would be issued if the ratio of ownership was not maintained. (R. 31-32.)[4]

On November 1, 1948, the three corporations received their new selling agreements together with two letters each covering the new policy. One to each company was a notification of unsatisfactory operations because all or a part of the ownership was held by a trust and the other, that their operations were unsatisfactory because all or part of the ownership was held by a holding company. Each letter stated that "it is the desire and policy of Chevrolet Motor Division that all ownership of the Chevrolet dealership be held directly by individuals approved by Chevrolet Motor Division" and that the new Chevrolet

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[4] The taxpayer had previously been advised by Chevrolet's Zone managers, Mr. Clarence DeLang and Mr. A. Strang, of the change in policy requiring the elimination of the trust and the holding company. (R. 154, 155, 165, 166.)

selling agreement was being delivered "upon the express representation by you that action will be taken to effect the foregoing objective not later than" a specified date. The date specified for elimination of ownership of stock by the trust was April 30, 1949, and by the holding company September 30, 1949. The probable consequence of failure to take the action required to satisfy the stock ownership policy would be that each corporation would receive a letter from Chevrolet stating that a new selling agreement would not be offered upon the expiration of the November 1, 1948, agreement because of non-compliance with its policy. (R. 34-35.)

Sometime after his meeting with Connell on September 1, 1948, and before the receipt of the new agreements and the letters on November 1, 1948, the taxpayer contacted Kenyon and advised him of his conversation with Connell. Taxpayer suggested to Kenyon that he confer with Thomas E. Dempsey, attorney for the owners and for the three corporations, and have him work out some plan to meet the requirements of Chevrolet. Kenyon discussed the matter with Dempsey. In the course of their discussions the possibility of Kenyon personally purchasing all of the stock of the three corporations owned by the trust was considered. This possibility was deemed not feasible because Kenyon did not have the money to make the purchase. Kenyon did not want the stock held by the trust sold to someone other than himself because he was desirous of maintaining his relative proportional voting interest and control in the dealerships. Kenyon and Dempsey also consid-

ered the possibility of eliminating the J. A. K. Company ownership of stock by means of a liquidation. Dempsey recommended that this not be done during the year 1948 because it would cost about $90,000 in taxes whereas if it were postponed until the Revenue Act of 1949 were passed the liquidation might be accomplished tax free. (R. 32-33.)

After being advised of the attorney's recommendation against the liquidation of J. A. K. Company in 1948, taxpayer wrote the zone manager of Chevrolet at Oakland, California, on October 16, 1948, stating, among other things, the following (R. 33-34):

> As you know, the J. A. K. Co., which is a Nevada corporation owned by James A. Kenyon, now owns 30 percent of the stock in Capitol Chevrolet Company, 30 percent in Mid-Valley Chevrolet, and 20 percent in Howell Chevrolet. Our attorney advises that if this J. A. K. Co. were to be liquidated at the present time, the tax situation is such that Mr. Kenyon and I would be subject to approximately $90,000 in tax.
>
> It would seem that if it were possible for you to permit us to postpone the change until the Revenue Act of 1949 passes both the House and the Senate it would be most helpful to us.
>
> * * * *
>
> At the present time we are working on a way to buy out the Trust by the different corporations. We believe this can be handled because although it is an irrevocable Trust, Mr. Kenyon has jurisdiction over the Trust until his daughter becomes of age.
>
> * * * *

> Because of the complications, I would appreciate Chevrolet Motor Division giving us six months or a year to work out of the seeming difficulties with which we are faced at the present time.

In addition to writing the foregoing letter the taxpayer also discussed the matter with Connell, the regional manager, and asked him whether or not it would be satisfactory if the liquidation of J. A. K. Company were delayed until the new law was passed, and it was agreed by Connell that some extension would be given. (R. 34.)

Pursuant to a prior agreement between Kenyon and the taxpayer, any tax liability which would result from the liquidation of J. A. K. Company was to be shared between them. This company was not liquidated in 1948 because of the income tax liabilities that would result from such liquidation and the possibility that they would be reduced by new tax legislation in 1949. (R. 34.)

Dempsey formulated a plan for eliminating the trust as stockholder of each corporation and it was presented at meetings of their boards of directors held in his office on December 21, 1948, and approved. The plan had two separate steps (R. 35-36):

> (1) The purchase by each of the three corporations of a certain number of shares in such corporation from the trust, as well as the purchase by each of these corporations of a sufficient number of shares from the other stockholders (except J. A. K. Co.) so that the Phelps-Kenyon control in Capitol Chevrolet Co. and Mid-Valley Chevrolet Co. would remain at 50

percent each and the Phelps-Kenyon-Howell control in Howell Chevrolet Co. would remain at 33 1/3 percent each; and

(2) The purchase by James A. Kenyon, personally, of the remaining shares owned by the Trust in each of the three corporations which were not to be purchased in Step (1).

The second step in the plan was expressly conditioned on the ability of Kenyon to secure the authorization of the Superior Court of the State of California of his purchase of the stock from the trust; and, as an alternative to be used in the event the court should fail to authorize such purchase, the plan provided that the three corporations would, respectively, purchase the remaining shares owned by the trust and that Kenyon would purchase the same number of shares from the other stockholders of each corporation, in such manner as to preserve the same percentage of control. (R. 36.)

At the meetings held on December 21, 1948, the directors of each corporation adopted the following resolution (R. 36-37):

> Whereas the purchase and redemption of stock according to the plan hereinabove set forth will reduce the corporation's working capital below its minimum requirements;
>
> Now, Therefore, Be It Resolved that the officers of this corporation be and they hereby are authorized and directed to borrow, in behalf of this corporation, from such banks or trust companies as they may in their judgment determine, an amount not exceeding $200,000, for such period of time and upon such terms and rate of interest as may to them in their discretion seem

advisable and to execute notes in respect thereto in the name of the corporation for the payment of the amount so borrowed.

Step 1 of the plan was executed on December 21, 1948, with the result that on that date the three corporations made distributions to stockholders in redemption of shares of stock, as follows (R. 37):

CAPITOL CHEVROLET CO.

Shareholder	*Amt.Distributed*	*Shares Redeemed*
F. Norman Phelps	$37,759.15	65
Alice Phelps	37,759.15	65
Patricia May Kenyon Trust	75,518.30	130

MID-VALLEY CHEVROLET CO.

F. Norman Phelps	$37,170.25	65
Alice Phelps	37,170.25	65
Patricia May Kenyon Trust	74,340.50	130

HOWELL CHEVROLET CO.

F. Norman Phelps	$23,254.00	50
Alice Phelps	23,254.00	50
Patricia May Kenyon Trust	46,508.00	100
Jackson Howell	46,508.00	100

Prior to December 21, 1948, Dempsey sent taxpayer copies of proposed minutes of the directors' meetings which he had prepared. Before receiving these minutes taxpayer was aware of the nature of the plan which was to be submitted to the directors, but its details had not theretofore been presented to him in writing. Howell was not present at the December 21, 1948, meeting of the directors of the Howell Chevrolet Company and had no knowledge of

the details of the plan until after it was adopted. Neither taxpayer and his wife nor Howell needed the money distributed to them in redemption of their stock. (R. 37-38.)

The shares of stock redeemed by the corporations were cancelled and the stated capital reduced accordingly. The operations of the corporations were not curtailed as a result of the redemptions, and they did not enter into any program of liquidation. (R. 38.)

The stock ownership in Mid-Valley Chevrolet Company and Capitol Chevrolet Company immediately before and after the redemptions was as follows (R. 38):

	Before—50%	After—50%
F. Norman Phelps	213 shares 25%	148 shares 25%
Alice Phelps	212 shares 25%	147 shares 25%
	Before—50%	After—50%
J. A. Kenyon, Trustee	170 shares 20%	40 shares 7%
J. A. Kenyon Company	255 shares 30%	255 shares 43%

The stock ownership in Howell Chevrolet Company immediately before and after the redemptions was as follows (R. 38):

	Before—33 1/3%	After—33 1/3%
F. Norman Phelps	150 shs. 16 2/3%	100 shs. 16 2/3%
Alice Phelps	150 shs. 16 2/3%	100 shs. 16 2/3%
	Before—33 1/3%	After—33 1/3%
J. A. Kenyon, Trustee	120 shs. 33 1/3%	20 shs. 3 1/3%
J. A. Kenyon Company	180 shs. 20%	180 shs. 30%
	Before—33 1/3%	After—33 1/3%
Jackson Howell	300 shs. 33 1/3%	200 shs. 33 1/3%

In the redemptions, the price paid per share in each of the corporations was as follows (R. 38):

Mid-Valley Chevrolet Co.	$571.85
Capitol Chevrolet Co.	580.91
Howell Chevrolet Co.	465.08

The total amounts actually distributed by each corporation through the distributions in issue were as follows (R. 39):

Mid-Valley Chevrolet Co.	$148,681.00
Capitol Chevrolet Co.	151,036.60
Howell Chevrolet Co.	139,524.00

If the corporations had purchased all the shares of the trust without redeeming shares of the other stockholders, only the following amounts would have been required (R. 39):

Mid-Valley Chevrolet Co.	$97,214.50
Capitol Chevrolet Co.	98,747.70
Howell Chevrolet Co.	55,809.60

If only the shares of the trust had been redeemed by the three corporations, their capital would not have fallen below the capital standard requirements set by Chevrolet. (R. 39.)

Because of the fact that the shares of other stockholders were redeemed along with the trust shares, the capital of the corporations fell below the standards set by Chevrolet. The additional cash distributions to the other stockholders placed a hardship on the corporations by requiring them to borrow funds. Failure to meet the capital standard requirements is reason for termination of a dealer's franchise. (R. 39.)

The 1948 redemptions did not eliminate either the trust or the holding company as stockholders of the three corporations. (R. 39.)

At the time of the 1948 distributions, the accumulated earnings and profits of each of the corporations were in excess of the total amount distributed to the shareholders. Earned surplus and undivided profits of each of the corporations as of December 31, 1948, after the distributions had been made, were as follows (R. 39-40):

Mid-Valley Chevrolet Co.	$275,536.12
Capitol Chevrolet Co.	285,666.90
Howell Chevrolet Co.	223,970.73

No dividends were ever declared or paid by any of the three corporations. (R. 40.)

The consummation of step 2 of the plan was commenced on June 1, 1949, by the filing by Kenyon, as Trustee of the Patricia May Kenyon Trust, of a petition to the Superior Court of the State of California, in and for the County of Los Angeles, for an order to sell the remaining trust stock in Capitol Chevrolet Company and Howell Chevrolet Company to those corporations, respectively, and by the liquidation of Mid-Valley Chevrolet Company. (R. 40.)

During the year 1950 and prior to July 26, 1950, J. A. K. Company was completely liquidated and all of the stock held by it in each of the three corporations was distributed to Kenyon. (R. 40.)

On July 26, 1950, Capitol Chevrolet Company purchased from Kenyon the 255 shares of its stock then owned by him and also purchased from the trust the 40 shares of its stock owned by the trust. Howell

Chevrolet Company purchased from Kenyon the 180 shares of its stock then owned by him and also purchased from the trust the 20 shares of its stock owned by the trust; and Mid-Valley Chevrolet Company purchased from Phelps the 148 shares of its stock then owned by him, and from Alice Phelps the 147 shares of its stock then owned by her. Thereafter during the year 1950 Mid-Valley Chevrolet Company was completely liquidated and dissolved and all of its assets transferred to its stockholders. (R. 40-41.)

Chevrolet did not object to the changes in the proportionate ownership and control of the three dealerships made during the year 1950. (R. 41.)

Upon these facts the Tax Court found that the distributions to the trust were not essentially equivalent to distributions of taxable dividends for the reason, stated in the court's opinion, that it was the first step in an integrated plan of complete elimination of the trust's ownership in the three companies. (R. 41-42.)

The court found as a fact that the distributions to the other stockholders, including the taxpayers herein, were made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends. (R. 41.) Mr. and Mrs. Phelps have petitioned the Court to review this latter finding. (R. 45-50.)

SUMMARY OF ARGUMENT

The Commissioner determined that taxable dividends resulted from the redemptions of portions of taxpayer's stock in three corporations. The Tax Court sustained this determination and found as a

fact that the distributions in redemption of the stock were made at such time and in such manner as to be essentially equivalent to distributions of taxable dividends under Section 115 (g) of the Internal Revenue Code of 1939.

The question of dividend equivalence has been held to be one of fact, and upon review the lower court's findings and decisions have not been disturbed unless they are "clearly erroneous."

This review necessarily requires an examination of the entire record by the appellate court. In making such an examination it will be discovered that there was ample evidence before the Tax Court to justify its ultimate findings, particularly in the light of the decided cases by this Court and other appellate courts.

The taxpayer contends that there was a legitimate business purpose for the redemption. Aside from the fact that the presence or absence of a business purpose is only one of the many "judicial criteria" to be considered in determining the question, the record shows clearly that there was no real corporate business purpose which motivated the redemptions in issue.

It has been held uniformly that no one factor is determinative of the issue and, that in the final analysis, it is the net effect or the reality of the situation which determines whether there has been, in fact, a distribution of a taxable dividend as opposed to a partial liquidation. In arriving at the net effect of the transaction the courts have developed a number of factors to be considered. The Tax Court reviewed each of these factors and found from the

record (1) a substantial accumulation of earnings and profits from which the redemptions were made; (2) no previous dividend declarations by any of the three corporations involved; (3) the absence of a corporate purpose; (4) no contraction or curtailment in business activities; (5) the particular plan of redemption originating with the stockholders; (6) the only benefit from the transactions accruing to the shareholders; and (7) a pro rata distribution of cash in cancellation of stock which resulted in a retention of the same proportion of control and fraction ownership by the same stockholder interests.

The Tax Court exercised its function with care and its findings are supported fully by the record.

ARGUMENT

The Tax Court Properly Found That the Redemptions of Portions of Taxpayer's Stock In Three Corporations Were Made At Such Time and In Such Manner As To Make the Transactions Essentially Equivalent To the Distribution of Taxable Dividends Under Section 115(g) of the Internal Revenue Code of 1939

The sole issue for determination is whether the evidence supports the Tax Court's finding as a fact that the redemptions of portions of taxpayer's stock were essentially equivalent to the distribution of a taxable dividend.[5]

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[5] The distributions in redemption of the stock owned by the Kenyon Trust are not involved in this appeal. The Tax Court, overruling the Commissioner's determination, found that these constituted a step in an integrated plan to eliminate the trust as a stockholder, and consequently were not essentially equivalent to a dividend. (R. 41-42.) The Commissioner has not cross-appealed from that determination.

Section 115 (g) of the Internal Revenue Code of 1939 (Appendix, *infra*), provides that—

> If a corporation * * * redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution * * * in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount * * * shall be treated as a taxable dividend.

The applicable Regulations (Treasury Regulations 111, Section 29.115-9 (Appendix, *infra*)) provide that the question of whether the distribution is equivalent to a taxable dividend depends upon the circumstances of each case, and that a redemption of a portion of stock pro rata among the shareholders will generally be considered as a distribution essentially equivalent to a dividend distribution.

The Commissioner determined in the instant case that there was a taxable dividend under the statute and the Regulations and the Tax Court partially sustained that determination. (R. 11, 43.)

The question is one of fact and the lower court's findings, if supported by the evidence, will not be set aside unless they are clearly erroneous and are induced by an erroneous view of the statute and the applicable decisions. This Court recognized this principle in the recent case of *Earle* v. *Woodlaw*, decided February 28, 1957 (1957 C.C.H., par. 9472). See also this Court's opinion in *Hirsch* v. *Commissioner*, 124 F. 2d 24; Section 7482(a), Internal Revenue

Code of 1954; and Rule 52 (a) of the Federal Rules of Civil Procedure.[6]

No one factor or fixed formula has been established for determining the question of dividend equivalence. In the *Woodlaw* case, *supra*, this Court quoted with approval the following statement of Judge Vinson in *Flanagan* v. *Helvering*, 116 F. 2d 937, 939 (C.A. D.C.):

> In determining whether a transaction is equivalent to a taxable dividend under § 115 (g), or whether it is a partial liquidation within § 115 (c), neither the Board of Tax Appeals nor the courts have laid down a sole decisive test.

The courts have given consideration to many elements in resolving the question, the principle ones having

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[6] Practically, all of the appellate courts have taken the view that each case of this type must be decided upon its own peculiar set of facts, that the net effect of the transaction is the fundamental question to be decided in administering Section 115 of the 1939 Code, and the determination of the lower court is in the words of the Third Circuit in *Ferro* v. *Commissioner*, decided March 20, 1957 (1957 C.C.H., par. 9498), "reviewable * * * only to the extent of ascertaining whether substantial evidence exists in the record to support that determination * * *." *Bazley* v. *Commissioner*, 155 F. 2d 237 (C.A. 3d), affirmed, 331 U.S. 737; *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1st); *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2d), certiorari denied, 329 U.S. 726; *Commissioner* v. *Roberts*, 203 F. 2d 304 (C.A. 4th); *Commissioner* v. *Sullivan*, 210 F. 2d 607 (C.A. 5th); *Chandler's Estate* v. *Commissioner*, 228 F. 2d 909 (C.A. 6th); and *Koepke* v. *Commissioner*, 230 F. 2d 950 (C.A. 6th); *Commissioner* v. *Snite*, 177 F. 2d 819 (C.A. 7th); *Randolph* v. *Commissioner*, 76 F. 2d 472 (C.A. 8th), certiorari denied, 296 U.S. 599; and *Jones* v. *Griffin*, 216 F. 2d 885 (C.A. 10th).

been stated by this Court in *Woodlaw* substantially as follows: (1) Was there an accumulation of earnings and profits from which the redemption was made; (2) was there a business purpose being carried out by the corporation, as distinguished from a benefit accruing to the stockholders, coupled with a suggestion of the transaction from the stockholders; (3) what has been the dividend policy of the corporation; (4) was there a contraction in the business, i.e., a partial curtailment or liquidation; and (5) did the stockholders retain their relative positions of control, influence and interest in the affairs of the corporation.

In reviewing the record, this Court will discover that the Tax Court's findings were not only free from clear error, but were fully warranted by the evidence.

The taxpayer's principal contentions are that (1) there was a legitimate business purpose for the distribution (Br. 24-29); (2) distributions were not made pro rata (Br. 30); and (3) there was a partial liquidation of the three corporations, and that consequently the payments in redemption should be treated as in part or full payment in exchange for corporate shares as provided for in Section 115 (c) of the 1939 Code (Appendix, *infra*). (R. 214; Br. 41.)[7]

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[7] Taxpayer's opening contention (Br. 19-22) that the Tax Court committed prejudicial error in finding that the distributions in question reduced the corporations' capital below the standards set by Chevrolet is unworthy of serious consideration. Taxpayer acknowledges (Br. 20-21) that the finding is correct as to two of the three corporations involved

Section 115 (Appendix, *infra*), covers distributions by corporations. Section 115 (a) (Appendix, *infra*), states as a general rule that any distribution to stockholders from earnings and profits is income and taxed as a dividend. Section 115 (c) provides an exception to Section 115 (a) if the distributions are in complete or partial liquidation of the corporation. However, the scope of Section 115 (c) is limited by the provisions of Section 115 (g) which states in effect that if stock is cancelled or redeemed at such time and in such manner as to make the distribution in whole or in part essentially equivalent to a dividend then such distribution shall be taxed as a dividend.

Because of the words "essentially equivalent", Treasury Regulations 111, Section 29.115-9, provide and the courts have held that the question is one of fact to be decided after the consideration of a number of relevant criteria. This application of certain "judicial criteria" to the particular set of facts is necessary to determine the net effect or reality of the transaction under consideration. It is clear from a review of the facts in the case that the net effect of the transaction was to drain off large accumulations of earnings and at the same time leave the continuing stockholders in exactly the same position of

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and, as pointed out below, it is also correct as to the third corporation. At any rate, as is plain from the Tax Court's opinion, read as a whole, this feature was not deemed conclusive, as taxpayer apparently assumes, but was merely one of many relevant factors considered by the Tax Court in reaching its decision.

ownership, control and influence as they had before the redemptions. Indeed, the retention of the same ratio of ownership is admitted by the taxpayer to be the principal reason for the particular transactions and the supplemental agreement entered into by the shareholders. (R. 157, 158, 197; Br. 33-34.)

A prerequisite to the application of Section 115 (g) is an accumulation of earnings and profits from which the distributions are made in the redemption of stock. There is no contention that there was a lack of sufficient earnings available in each of the three corporations from which the redemptions herein involved were made. Aside from the fact that the presence of sufficient earnings was stipulated (R. 21) and admitted by taxpayer on brief (p. 32), the record shows that after the distributions, the earned surplus and undivided profits accounts of each corporation exceeded $200,000 (R. 39-40). The testimony is that the corporations were making "quite a lot of money * * *." (R. 88.) Instead of distributing the very substantial earnings to the stockholders in the form of dividends, they were allowed to accumulate. (R. 21, 40; Br. 30.) While there is no implied criticism of the directors in not declaring dividends during former years, this lack of dividend record is strong evidence that the later distributions took the place of proper and justifiable dividends. This and other appellate courts have recognized as important factors, in determining the question of dividend equivalence, the past record in respect to the payment of dividends, and whether, both before and after the distributions, the corporations had substantial accumulated earn-

ings in excess of the amounts disbursed. *Earle* v. *Woodlaw*, *supra*; *Boyle* v. *Commissioner*, 187 F. 2d 557 (C.A. 3d), certiorari denied, 342 U.S. 817; *Flanagan* v. *Helvering*, *supra*; *Jones* v. *Griffin*, 216 F. 2d 885 (C.A. 10th); *Commissioner* v. *Snite*, 177 F. 2d 819 (C.A. 7th); *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2d), certiorari denied, 329 U.S. 726.

The lower court found that there was no contraction or curtailment in the operations of the three dealerships and that there was no plan of liquidation. (R. 38.) The taxpayer and Mr. Howell testified that the businesses continued as before, and there was no curtailment after the distributions (R. 90, 211-212); and on brief, the taxpayer states (p. 24)—

> not only did the corporations not adopt any plan for the contraction of their businesses, but also there was no intent to contract * * *.
>
> * * * *
>
> ultimate dissolution or ultimate contracted operations were never contemplated.

In arriving at the net effect of the transaction support for finding a taxable dividend has been found in the lack of a manifestation of a policy of contraction or liquidation which would necessarily require a diminution in the capital structure. The evidence here shows a continuation of full and successful operations participated in by the taxpayer and the other stockholders to the same extent as before the redemption of a portion of the stock. (R. 90, 211-212.)

The taxpayer contends that the redemptions were made necessary by a demand from Chevrolet that the

trust be eliminated and from a suggestion by Mr. Connell, Chevrolet's regional manager, that the same ratios of control be maintained in the three corporations. (Br. 24-29.) These contentions form the basis for the argument that the sole purpose of the distributions was a legitimate corporate purpose and that the suggestion therefore came from the corporations. (Br. 24.) The Tax Court refutes this contention effectively by stating in its opinion (R. 42-43):

> In substance the distributions simply transferred to these stockholders accumulated earnings and profits of their corporations. It is no answer to say that these transactions had their origin in the demand of Chevrolet that the trust be eliminated as a stockholder. That objective could have been achieved, and indeed with less strain upon the corporations, merely by redeeming the shares of the trust. However, Kenyon did not wish to have his control diluted, and Connell, the regional manager for Chevrolet, had himself suggested to Phelps that it would be fair to preserve the same ratios of control. But that suggestion did not represent Chevrolet policy, and we do not believe, on the evidence, that Phelps regarded it as such.[1] It was an objective that the parties themselves would undoubtedly have desired to attain, wholly apart from any suggestion emanating from Connell. Certainly,

[1] In reaching this conclusion we do not rely upon the testimony given by Connell in his deposition, objected to by petitioners, that Phelps understood the suggestion as being his [Connell's] "rather than General Motor's suggestion or policy".

> petitioners, who have the burden of proof, have not shown otherwise.

The lower court had much evidence in the record to support such a statement. There is no dispute as to the dominant motive behind the moves of the taxpayer, Mr. Kenyon and their attorney in devising a plan of redemption. In considering and rejecting plans they were thinking not merely of a way of eliminating the trust, but at the same time of attaining the proportionate control of Messrs. Kenyon and Howell and the taxpayer in the three corporations.[8] (R. 32, 35-36, 69-70.) Kenyon and his attorney, who was also attorney for the taxpayer, Howell and the three corporations, discussed the possibility of Kenyon purchasing all of the stock held by the trust; but, this plan was not feasible because Kenyon did not have the necessary funds. (R. 32, 181.) Before Chevrolet granted an extension of time in which to eliminate the holding company, consideration was given to its liquidation and the transfer of its stock in the dealership to Kenyon. This step was abandoned because of the possible tax consequences of such a move in 1948. (R. 155-156.) Evidently, from a reading of taxpayer's brief (Br. 34-40; Supp. R. 1-21),[9] many alternatives were considered and re-

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[8] In his testimony Mr. Kenyon answers questions concerning the requirements of the letters to the corporations from Chevrolet. These letters required only that the trust and holding company be eliminated; however, the plans discussed were directed at maintaining Kenyon's percentage of ownership and control. (R. 181-182.)

[9] Supp. R. references are to the portions of the record printed in the appendix to taxpayer's brief.

jected, not because they were beneficial or harmful to the corporations, but, rather because they were financially undesirable from the point of view of Kenyon and the taxpayer.

The first notice of Chevrolet's change in policy concerning the ownership of stock in dealerships by trust and holding companies did not come from Mr. Connell. (R. 154, 165-166.) Mr. Clarence DeLong or Mr. A. W. Strang, or possibly both, discussed the matter with the taxpayer and there is no indication that they spoke of the desirability of maintaining the proportionate stock ownership. (R. 165-166.) Subsequent to this discussion Mr. Connell discussed the situation with taxpayer and after advising him of the change in policy, suggested that it might be desirable to continue the Kenyon-Howell-Phelps control of the dealerships. (R. 166.)[10] Shortly after the discussion with Connell, in September of 1948, the taxpayer wrote to two zone managers and advised them that steps were being taken to eliminate the trust and the holding company. (R. 153-154.) And, in a letter to Mr. Strang in October, the taxpayer

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[10] Mr. Connell says that he was not quoting Chevrolet policy when he suggested the retention of control, but, rather he was making only a personal suggestion. (R. 171-172.) His other observations of this discussion with the taxpayer are (1) Chevrolet was not concerned with how the new policy was carried out (R. 166); (2) he did not advise the taxpayer on the subject, but rather only discussed it (R. 165); (3) there was no implied threat that a new selling agreement would not be issued unless the control continued (R. 173); he did not order a retention of the percentage control (R. 176); and he did not believe that the taxpayer understood his suggestion to be General Motor's policy. (R. 172).

asked for an extension of time in which to eliminate the holding company and advised him that plans were being worked out to eliminate the trust from stock ownership. (R. 155-156.) No mention was made in any of this correspondence of the suggestion to retain control proportionately in the remaining stockholders. Then, on November 1, 1948, letters were received from zone managers by the three corporations forwarding new selling agreements and stating that the arrangements were unsatisfactory because portions of the stock in the dealerships were owned by the trust and holding company. (R. 143-153.)[11] The taxpayer, who had extensive experience with General Motors in various capacities, must have known that the selling agreements were the only agreements between the parties and that the letters forwarding them expressed the only official position of Chevrolet. (R. 132-133.) In his statement of facts taxpayer acknowledges that the letters were sent by Chevrolet in "conformance with its new policy * * *." (Br. 11.) The agreements with Chevrolet in effect in the years involved here were personal agreements with the taxpayer (R. 112, 168-169, 171) and could not be modified except in writing approved by both parties (R. 133). Thus, almost two months before the meeting of the board of directors, which was held on December 21, 1948 (R. 36), the tax-

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[11] In placing the letters into evidence taxpayer's counsel offered them merely to show the reason for the action taken, .i.e, the elimination of the trust. They could not be used otherwise because no mention of proportionate control is contained in them. (R. 60-64.)

payer knew that the only requirement of Chevrolet was the elimination of the trust and the holding company and that an extension until the following year had been granted with regard to the holding company. He knew at that time, if indeed, he did not know already, that there was no requirement that the ratio of control be maintained.[12] (R. 92-93.) And, at this point the taxpayer also knew of the details of the plan devised by Kenyon and their attorney. (R. 37, 71.)

It is clear from these facts, as well as others found in the record,[13] that the suggestion for the redemp-

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[12] In his deposition, the taxpayer indicated that he considered the change in policy to cover only the trust and the holding company when he said (R. 66):

> I informed Mr. Connell that I had been with Chevrolet long enough to know that if they requested that we take the holding company and the Trust out * * * that they meant it, and we would do so immediately.

Then, in discussing the financial situation, he stated that the only reason the companies were below the minimum working capital standards (R. 104-105)—

> was because this emergency came up when they insisted they get the Trust and the holding company out of the corporation.

[13] In his statement to the court below taxpayer's counsel explained that the plan suggested by Kenyon and the attorney was designed "to make the takeout in such a manner that after it was completed, Mr. Kenyon and Mr. Phelps would equally control the capital * * *." (R. 197.) In reality because the prime consideration was the welfare of the shareholder's interest, the trust was not eliminated completely in 1948, and no effort was made to eliminate the holding company. (R. 39.) As the Tax Court pointed out, the trust could have been eliminated with a much lower expenditure of funds (R. 42-43), and the holding company could have been liquidated even though by doing so there would

tions came from the taxpayer, Kenyon and their attorney; and, that the particular plan adopted was for the benefit of the share holders, no legitimate corporate purpose being served. Rather than benefitting the corporations, the large disbursements of cash to all of the shareholders reduced "the corporation's working capital below its minimum requirements" and necessitated the passing of resolutions authorizing the directors to borrow $200,000 for each dealership. (Supp. R. 35, 41, 42, 48.) The taxpayer contends that the Tax Court erred in finding that the redemptions caused the capital of the dealerships to fall below the standards set by Chevrolet. (Br. 19.) Taking his view of the record, the taxpayer admits that the finding was correct with regard to two of the three corporations (Br. 20-21), and that the corporations continued "to grow notwithstanding the temporary setback occasioned by the reductions in their capital resulting from the distributions which were made" (Br. 24). It is submitted that the court below had ample evidence in the record to support such a finding. In addition to the resolutions authorizing the borrowing of $600,000 to correct the situation, there is an indication that such borrowings were carried out. Mr. Howell testi-

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have been some tax liability attached to such a move. If the large earned surplus had been distributed as dividends before any redemption of stock, the holding company would have been in a position to purchase the trust shares, and the trust would also have received some benefit from the ownership of stock. In reality it never participated in the profits from the operation of the dealerships.

fied that the manner of withdrawing money to eliminate the trust (R. 209)—

> placed a hardship on the operation of Howell Chevrolet * * * [and] it was necessary for Howell Chevrolet to borrow money on inventories which had not been the case prior to the taking out of the trust, and the holding company.

Howell also was of the opinion that they would have been "much better off had those funds remained in the business." (R. 212.) The taxpayer did not recall, but thought that it was necessary to borrow money (R. 91), particularly for Capitol Chevrolet (R. 108-109). As a result of the redemptions it was necessary for the dealerships to "be very frugal" and to take other measures which would raise the capital standards to those required by Chevrolet. (R. 104-105.)[14] Under the facts as revealed in the record it cannot be maintained that the method used to eliminate the trust was beneficial to the corporation or was done to accomplish a corporate purpose. In reality, the benefactors of the plan were Kenyon, who retained his ownership and voting position, and the shareholders, including taxpayer, who received substantial sums of money in redemption of a portion of their stock, while remaining in exactly the same relative position of ownership, control and interest in the affairs of the three corporations. To

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[14] The Capital Standard Agreement between the dealerships and Chevrolet provides that failure to meet the minimum requirements constitutes a ground for the termination thereof. (R. 139.) This is the basis for the Tax Court's finding (R. 39), objected to by taxpayer (Br. 19).

contend that the maintenance of the Kenyon-Howell-Phelps control of the dealerships was for the benefit of the corporations is to overlook the facts previously discussed and considered by the court below and to ignore subsequent events which took place less than two years later (in July of 1950) when the proportionate ownership was changed completely, apparently with the approval of Chevrolet. (R. 41.) Also at about that time the holding company was liquidated and its assets turned over to Kenyon and the trust was eliminated completely from ownership in the dealership. (R. 40.)

The presence or absence of a business purpose for the redemption is one of the factors considered by the courts in a determination of dividend equivalence. At most, however, it has been characterized as only one of the elements and has never been controlling. This Court stated the general rule in *Earle* v. *Woodlaw, supra,* when it said that the purpose to be considered along with other factors must be corporate as distinguished from a benefit accruing to the shareholders. A mere change in capital structure has been held not to be a legitimate business reason for distributions under Section 115. *Bazley* v. *Commissioner, supra.* In *Smith* v. *United States*, 130 F. Supp. 586 (C. Cls.), the court said (p. 591):

> It has been recognized by the courts that a legitimate business purpose, separate from tax savings, is an important although not conclusive factor to consider in determining the applicability of section 115 (g). *Keefe* v. *Cote*, 5 Cir., 213 F. 2d 651; *Commissioner of Internal Rev-*

enue v. *Sullivan, supra; Commissioner of Internal Revenue* v. *Snite*, 7 Cir., 177 F. 2d 819; *Smith* v. *United States*, 3 Cir., 121 F. 2d 692, and the cases there cited.

In contending that the distributions were not made pro rata the taxpayer runs squarely into his theory of the case. (Br. 22.) The principal objective was to maintain Kenyon percentage control of the three corporations and this was one of the two results "which was accomplished by the distributions which were actually made." (Br. 33.) Throughout the record and in his brief taxpayer refers to the Kenyon-Phelps control of Capitol Chevrolet and Mid-Valley Chevrolet and of the Kenyon-Phelps-Howell control of Howell Chevrolet. (R. 8, 46, 58, 158; Br. 6, 10, 34; Supp. R. 31-32.) The plan finally adopted was aimed at maintaining the existing voting interest and required a supplemental agreement between the shareholders to preserve the same percentage of control in the event of the failure of Kenyon to obtain state court consent for his purchase of the shares of the trust. (R. 157-159; Supp. R. 31-48.) There is no dispute as to Kenyon's control of the trust. By its terms, he had the power to deal with the property as absolute owner thereof including the power of sale. (Supp. R. 25-27.) In his letter to Strang dated October 16, 1948, the taxpayer assures him of this complete control (Br. 9-10) and in his testimony states that it was not necessary for Kenyon to consult with anyone before voting the stock owned by the trust (R. 105).

It is not contended, and indeed, there could be

no contention, that there was any change in Kenyon's position in the dealerships. After the distributions he remained in control of 50 percent of the stock in Capitol and Mid-Valley and in one-third of the stock in Howell Chevrolet. He continued as a member of the board of directors of the three corporations and remained as one of three principal officers. His interest in the affairs of the corporations continued unabated and his position of influence and participation in the operations was not diminished in any manner. Likewise, the taxpayer and the other stockholders maintained their same percentage of ownership of stock in the dealerships and taxpayer and Howell continued their memberships on the board of directors and as principal officers of the corporation. (R. 19, 38.) In the words of the Tax Court the "stockholders in question emerged with the identical fractional interests in the corporation * * *." (R. 42.)[15]

The final contention of the taxpayer, namely, that the redemptions "constituted partial liquidations of those corporations" is submitted without argument or authority. (Br. 41-42.) It is effectively answered in his own words on brief when he says (p. 24):

> Furthermore, not only did the corporations not adopt any plan for the contraction of their busi-

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[15] Chevrolet recognized this equality of control and interest and held Kenyon and taxpayer personally liable under the selling agreements. (R. 168-169.) Kenyon and the taxpayer were the only individuals named in the agreements with Capitol and Mid-Valley; and the taxpayer, Kenyon and Howell were the individuals named in the agreement with Howell Chevrolet. (R. 58, 59, 112.)

> nesses, but also there was no intent to contract and each of the corporations hoped, expected to, and did continue to grow notwithstanding the temporary setback occasioned by the reductions in their capital resulting from the distributions which were made.
>
> *   *   *   *   *
>
> ultimate dissolution or ultimate contracted operations were never contemplated.

It is clear that the transactions resulted in the distribution of large amounts of current earnings to the shareholders in the guise of stock redemptions, and that when the transactions were completed the taxpayer, Kenyon, Howell and the other shareholders "emerged with the identical fractional interests in the corporation which they had owned before * * *." (R. 42.)

We submit that the Tax Court exercised its function with care in considering all the facts and that its findings and decision are supported fully by the record. It cannot be said that from a review of the record the court below was clearly erroneous in its application of the facts to the statute, the Regulations and the decided cases.

In challenging the Tax Court's determination taxpayer has failed to distinguish between the distributions in redemption of the trust shares (which the Tax Court found were a step in an integrated plan to eliminate the trust as a stockholder and hence were not essentially equivalent to a dividend), and the distributions here in question, which were designed to leave the remaining stockholders including the tax-

payer in the same relative position of ownership and control of the corporations that they previously occupied. Insofar as the redemption of the trust shares is concerned, the arguments advanced by taxpayer were accepted by the Tax Court. But insofar as the redemption of taxpayer's shares is concerned, the arguments have no applicability or validity, and were properly rejected by the Tax Court.[16]

[16] Moreover, even as to the redemption of the shares here in question taxpayer's argument is replete with inconsistencies. For example, on the one hand taxpayer contends that the redemptions were effected in order to comply with Mr. Connell's "suggestion" that the proportionate ownership and control as between taxpayer and Kenyon be preserved (Br. 26-29, 33-34), yet he also contends that their proportionate interests were changed as a result of the redemptions (Br. 30-32). Again, for example, taxpayer on the one hand contends that the distributions in question did not cause the corporations' capital to fall below the standards required by Chevrolet (Br. 19-22), yet in explanation of non-payment of ordinary dividends during the taxable year he contends that dividend payments were rendered "impossible by the very distributions which are here in question for the reason that such distributions reduced the corporations' working capital below the minimum required for their continued operations" (Br. 31-32).

CONCLUSION

The decision of the court below is correct and should be affirmed.

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MAY, 1957

APPENDIX

INTERNAL REVENUE CODE OF 1939:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) [as amended by Sec. 147, Revenue Act of 1942, c. 619, 56 Stat. 798] *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation, shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or

on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. * * *

*   *   *   *   *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

*   *   *   *   *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

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(26 U. S. C. 1952 ed., Sec. 115.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.115-9. *Distribution in Redemption or Cancellation of Stock Taxable as a Dividend.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend,

the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. A bona fide distribution in complete cancellation or redemption of all of the stock of a corporation, or one of a series of bona fide distributions in complete cancellation or redemption of all of the stock of a corporation, is not essentially equivalent to the distribution of a taxable dividend. If a distribution is made pursuant to a corporate resolution reciting that the distribution is made in liquidation of the corporation, and the corporation is completely liquidated and dissolved within one year after the distribution, the distribution will not be considered essentially equivalent to the distribution of a taxable dividend; in all other cases the facts and circumstances should be reported to the Commissioner for his determination whether the distribution, or any part thereof, is essentially equivalent to the distribution of a taxable dividend.

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